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SUBJECT: KOSOVO TAKING PROACTIVE APPROACH FOR DONORS
CONFERENCE PREPARATION

Sensitive but unclassified - please protect accordingly.

11. (SBU) Summary. In preparation for a donors conference, the PISG hopes to complete the draft of the Medium Term Expenditure Framework by late April and have a final document by late May highlighting Kosovo's development needs and priorities. The PISG started discussions with the IMF on April 13 to negotiate a letter of intent, which is crucial for establishing the economic and fiscal policies the PISG must adhere to in order to receive donor and international financial institution assistance. The Ministry of Finance and Economy appears willing to negotiate and compromise with the IMF on politically sensitive but budget-busting legislation, such as the law on providing benefits to former Kosovo Liberation Army (KLA) fighters, and other draft legislation dealing with labor, health insurance and social welfare. The political commitment of top Kosovo leaders and Kosovo parliamentarians to this belt-tightening, however, is less certain, and donors will need to work together to impress upon the PISG the necessity of making these changes. USOP, along with the other donors, will encourage flexibility from the PISG and IMF to ensure that the donors conference remains on track. End Summary.

PISG ON TRACK WITH MTEF PREPARATION

12. (SBU) Officials of the Ministry of Finance and Economy (MFE), along with assistance from USAID-funded advisers, told us recently that a draft Medium Term Expenditure Framework (MTEF) would be ready by late April for donor countries and agencies and noted that a final product should be complete by late May. These officials believe the MTEF provides a much clearer picture of PISG priorities, which include the rule of law (judicial reform, development of the public prosecutors office and resolution of the case backlog of courts), energy sector (construction of distribution and transmission lines, Sibovc Southwest mine development, and electricity bill collection improvements), transportation (road and highway construction), and education (education reform, classroom construction for primary and secondary education, hiring more teachers and teacher training). The MTEF estimates that almost two billion euros will be needed over six years for capital and non-capital expenditures in these areas. Donors are expected to provide half of that amount, which excludes debt relief and technical assistance.

LOI WITH IMF CRITICAL TO KEEP DONOR CONFERENCE ON TRACK

13. (SBU) MFE officials said that before the official MTEF can be presented to donors, the ministry must negotiate a new letter of intent (LOI) for economic and fiscal policies with the IMF. MFE officials said this was necessary since the EU and World Bank must have a LOI for the donor conference, noting this document establishes the economic and fiscal policies to which the PISG must adhere in order to receive donor assistance. MFE Minister Haki Shatri started discussions with the IMF to negotiate a new LOI on April 13.

MFE HOPING FOR IMF FLEXIBILITY ON SENSITIVE LOI ISSUES

14. (SBU) The MFE hopes it can negotiate with the IMF on two politically sensitive but expensive budget issues: spending for social welfare programs (implementing the law on benefits to former Kosovo Liberation Army (KLA) members, and redrafting legislation for pensions, labor and health insurance benefits) and the 0.5 percent limit on growth in recurrent spending in the Kosovo Consolidated Budget (KCB). On social welfare issues and in particular the budget-busting KLA law, the MFE proposes to tighten the eligibility criteria based on financial need and eliminate hard-to-quantify provisions of the legislation such as electricity subsidies, customs and tax exemptions, purchase of cars for KLA veterans by the PISG, academic scholarships, and free room and board and textbooks at universities. MFE officials asserted that under the strict criteria proposed by Minister Shatri, the cost of the KLA law would be 23 million euros per year instead of 80 million euros per year as estimated by senior PISG officials. MFE officials said that to save more money, Minister Shatri would propose annulling the health insurance legislation recently passed by the Kosovo Assembly, redrafting the labor and pension legislation currently under review in the Assembly, and replacing them all with more modest legislative provisions.

15. (SBU) The MFE will ask the IMF to relax the 0.5 percent limit on growth in recurring spending, increase the basic pension from 40 to 50 euros per month, and hire more teachers at higher salary levels. MFE officials estimate that these additional expenditures will total 43 million euro. The MFE believes that the IMF would be willing to relax the 0.5 percent limit rule for this LOI. For its part, the MFE remains committed to reducing public sector employment by up to 10 percent, but advocates a gradual, systematic approach to be completed by 2009. The international community, including the World Bank, has urged both the IMF and PISG to be flexible in order to complete the LOI in a timely manner. European Commission officials have signaled that the European Union is willing to consider a flexible approach towards relaxing the 0.5 percent limit for recurrent spending.

COMMENT

16. (SBU) The commitment of the MFE to maintain the timeline for submitting the MTEF to donors is an encouraging sign that the PISG understands the importance of this process. Nevertheless, there are serious concerns -- including within the MFE itself -- that senior-level PISG officials will not support some of Minister Shatri's proposals, particularly those that deal with the KLA law and social welfare spending.

We will need a unified line among the donor community to impress upon Kosovo's political leadership and, even more difficult, upon its parliamentarians that extravagant social spending will endanger donor commitments. USOP will continue to work with the PISG and international community to encourage flexibility and compromise to ensure that the donors conference takes place in a timely manner and is fully integrated with Kosovo's post-transition needs. End Comment.

18. (SBU) USOP clears this cable in its entirety for release to UN Special Envoy Ahtisaari.
KAIDANOW